



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

Release Number: **200716035**

Release Date: 4/20/07

Date: January 25, 2007

U.I.L. – 512.01-00 No Third Party Contacts

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Association =

Year 1 =

Year 2 =

x =

y =

z =

Dear \_\_\_\_\_ :

This is in response to Association's ruling request, as amended dated October 10, 2006, that the proposed sale of buildable lots will not adversely affect Association's exempt status under section 501(c)(4) of the Internal Revenue Code and be subject to tax on unrelated trade or business income under 511(a)(1) of the Code.

Association is a homeowners association exempt under section 501(c)(4) of the Code. Association was established in Year 1 and currently has approximately x paying members.

Association owns certain parcels of land and has set aside some area as recreational and parkland preserve for the use of the public, such as a park and playground, tennis courts, hiking trails, and a playbowl area. In addition, it has held in reserve watershed land for its water supply. Association administers and maintains these common areas and runs a full state water treatment facility for the homes in the community.

Due to financial hardship, in Year 2, Association's membership authorized the sale of commonly

held lots to raise needed funds for its activities. Association has y potentially buildable and z non-buildable lots that it plans to sell. Buildable lots are parcels that are 20,000+ square feet with physical characteristics that may be suitable for development. The buildable lots will be sold on the open market through a real estate agent. Association will not make any improvements on the lots and will not advertise their sales.

Non-buildable lots are parcels not suitable for building based on size, approximately 5,000-7,000 square feet, or the characters of the terrain. Association will only offer to sell the non-buildable lots to adjacent property owner members with the stipulation that, upon purchase, the lot would be merged with their existing property. The sale of lots will be announced in Association's newsletter.

Association has no plan to conduct any more sales of land after the sale of the lots. The income will be used to fund Association's capital reserve fund, held in interest-bearing money market account, for use in the administration and maintenance of common areas used by the public and the community.

Section 501(c)(4) of the Code provides exemption that includes organizations not organized for profit but operated exclusively for the promotion of social welfare and the net earnings of which are devoted exclusively to charitable, educational or recreational purposes.

Section 511(a)(1) of the Code provides the imposition of tax for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in sections 501(c) and 401(a).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" to mean the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modification provided in subsection (c).

Section 512(b)(5) of the Code provides for the exclusion from the computation of unrelated business of all gains or losses from the sale, exchange, or other disposition of property other than

- (A) stock in trade or other property of a kind which would properly includible in inventory if on hand at the close of the taxable year, or

- (B) property held primarily for sale to customers in the ordinary course of the trade or business.

Section 513(a) of the Code defines the term "unrelated trade or business" to mean any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

In *Brown v. Commissioner*, 143 F. 2d 468 (5th Cir. 1944), the organization owned 500 acres of unimproved land used for grazing purposes. The organization subdivided the land into lots, cut in streets, installed storm sewers, constructed gas and electric lines and other activities of the kind usually carried out by a real estate company, and sold 20 to 30 lots each year. The court held that the organization was holding lots for sale to customers in the regular course of business.

In *Adam v. Commissioner*, 60 T.C. 996 (1973), the court indicates that several guidelines generally utilized to determine whether an organization's activity in a land transaction was a trade or business include the following: (1) The purpose for which the asset was acquired; (2) the frequency, continuity, and size of the sales; (3) the activities of the seller in the improvement and disposition of the property; (4) the extent of improvements made to the property; (5) the proximity of sale to purchase; and (6) the purpose for which the property was held during the taxable year. The court applied such guidelines in holding that the organization was not engaged in a trade or business finding that the organization, among other things, bought and sold unimproved properties, did not perform significant activities in buying, selling and improving the properties, and did not devote substantial time in the transactions.

In *Fairley v. Commissioner*, 7 T.C. 198 (1946), the organization sold 25 lots out of a tract of land previously used in his nursery business. The organization made no active effort to sell and did not develop the property. The Tax Court described the sale as "in the nature of a gradual and passive liquidation of an asset" and held that the income derived from the sales represented capital gains income.

Our analysis indicates that Association plans to sell land that it acquired for a long time for its exempt purposes. Due to financial hardship and the need to generate funds necessary for its activities, Association has determined that it is in its best interest to sell the land in order to fund its activities. The proposed sale indicates meeting the guidelines for non-treatment as a trade or business as set forth in *Adams v. Commissioner, supra*. These include the acquisition of the assets for exempt purposes, the significant time between the acquisition and selling of the assets, and the no plan for improvement on the assets or no advertisement of their sales. See also *Farley v. Commissioner, supra*.

The proposed transactions are distinguishable from the activities of the organization described in *Brown v. Commissioner, supra*, which the court held to be an ordinary trade or business. Whereas that organization made significant improvement in selling the property, Association will not make improvement on the property to be sold.

Based on the foregoing, we rule, as requested, as follows:

1. Association's proposed sale of y buildable lots will not adversely affect its exempt status under section 501(c)(4) of the Code.
2. Association's proposed sale of y buildable lots will not give rise to unrelated business taxable income subject to tax under section 511(a)(1) of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Debra J. Kaweck  
Manager, Exempt Organizations  
Technical Group 2

Enclosure  
Notice 437